

Internal Revenue Service

**memorandum**

CC:TL-N-7847-87

Br2:DCFegan

date: AUG 24 1987

to: District Counsel, Milwaukee  
Attn: Ronald J. Long

CC:MIL

from: Director, Tax Litigation Division

CC:TL

subject:

[REDACTED]  
Nondocketed case

This is in reply to your memorandum of May 26, 1987, requesting technical advice concerning the above-named taxpayer.

ISSUE

Whether all or any portion of the distributions to the subject cooperative's patrons qualify as "patronage dividends" paid pursuant to a pre-existing legal obligation.

CONCLUSION

No portion of the distributions qualify as deductible "patronage dividends."

FACTS

The taxpayer is a nonexempt farmers' cooperative organized under the laws of Wisconsin and filing calendar year tax returns based on the accrual method of accounting. Its purpose is to sell the products of dairymen and to purchase their supplies and equipment.

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For [REDACTED] and [REDACTED], the taxpayer claimed patronage dividend deductions 1/ of \$[REDACTED] and \$[REDACTED]. Upon examination, the revenue agent determined that [REDACTED] percent of these amounts should be disallowed because taxpayer's bylaws allow up to [REDACTED] percent of the net accumulations to be set aside for educational purposes. There were no funds set aside for such purposes from accumulations in [REDACTED] or [REDACTED]. The Appeals Division determined the discretion to set aside funds extended to the entire net accumulations, and has proposed to disallow the entire patronage dividend deductions claimed.

The issue is whether all or any portion of the claimed patronage dividend deductions should be disallowed because they were not made pursuant to a binding obligation. The pertinent bylaw provisions are set forth below:

BYLAW 5. BUSINESS & ACCUMULATIONS

Section 2. Net Accumulations, Distributions.

In its annual distribution of the net accumulations of the Association, the Board of Directors may (a) set aside a reasonable amount for such necessary or statutory purposes as the Directors in their discretion decide; (b) declare dividends of not over [REDACTED] percent ([REDACTED]%) in any year on the paid-up capital stock; (c) set aside as an educational fund for teaching cooperation not exceeding [REDACTED] percent ([REDACTED]%) of the remainder.

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1/ Whether patronage distributions are "exclusions" or "deductions" is unclear. Both terms have been used in this memorandum. With respect to whether the tax treatment accorded patronage dividends is an exclusion or a deduction from a taxpayer's gross income, see Mississippi Valley Portland Cement Co. v. United States, 408 F2d 827, 831 n. 6 (5th Cir. 1969), citing, *inter alia*, Farmers Cooperative Co. v. Birmingham, (N.D. Iowa 1949) and concluding that a patronage dividend is an item "excluded" rather than "deducted" from taxpayer's gross income. Cf., e.g., Farm Service Cooperative v. Commissioner, 619 F2d 718 (8th Cir. 1980), which refers to a "deduction" for patronage dividends.

This Co-operative shall be operated in such a manner that all of its net margins derived from business done with or for members, shall at the moment of receipt be owned by its members and all of its net margins derived from business done with or for a non-member shall be owned by the Co-operative and shall constitute income to the Co-operative for the fiscal period from which they are derived.

The (sic) at the close of each fiscal year, the Co-operative shall allocate to each member on a patronage basis, each member's share of net margins and may in addition, if it elects to do so, allocate on a percentage basis to the members in (sic) any part or all of the net margins derived from non-member business.

#### DISCUSSION

Subchapter T of the Internal Revenue Code (sections 1381-1388) applies special rules to certain corporations operating on a cooperative basis.

Section 1382(b) of the Code allows a deduction for "patronage dividends" paid with respect to patronage of a cooperative. "Patronage dividends" are defined in section 1388(a) as amounts paid to a patron (1) on the basis of quantity or value of business done with or for such patron, (2) under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount so paid, and (3) which is determined by reference to the net earnings of the organization from business done with or for its patrons.

The regulations provide that the obligation pursuant to which the payments are made must be "a valid enforceable written obligation...which existed before the cooperative organization received the amount so paid." Amounts paid by a cooperative organization are paid under a valid enforceable written obligation if such payments are required by State law or are paid pursuant to provisions of the bylaws, articles of incorporation, or other written contract, whereby the organization is obligated to make such payment. The term 'net earnings' includes the excess of amounts retained by the

organization to cover expenses or other items over the amount of such expenses or other items. Treas. Reg. § 1.1388-1(a)(1). "Loosely speaking, then, 'net earnings' is what remains of a cooperative's gross receipts after deductions for the usual corporate operating expenses." Union Equity Cooperative Exchange v. Commissioner, 58 T.C. 397, 411 n. 16 (1972).

The pre-existing legal obligation requirement for payments to be considered patronage dividends goes back to the so-called Rochdale principles of economic cooperative theory. One of these principles is that the organization to be considered a cooperative must provide for the vesting in and the allocation among worker-members of all fruits and increases arising from their cooperative endeavor (net earnings) in proportion to the worker-members' active participation in the cooperative endeavor. Puget Sound Plywood, Inc. v. Commissioner, 44 T.C. 305, 308 (1965). When such a legally enforceable obligation exists to refund gross receipts in excess of costs and operating expenses, there is no tax on these net earnings at the entity level. I.R.C. 1382(b) and 1388(a).

The justification for this treatment rests upon the fact that these patronage dividends represent either an additional consideration due the patron for goods sold through the cooperative or a reduction in the purchase price of supplies and equipment purchased by the patron. The amounts which may be excluded as patronage dividends are not limited to the distributions made in cash but include amounts retained by the cooperative and distributed in forms other than cash.... [A]ny receipts of a cooperative association which it fails to allocate to its patrons must be included in the taxable income of the association to the same extent as in the case of commercial corporations generally. This is true of any amounts set up in a reserve account as well as net margins remaining after provision for reserves.

Rev. Rul. 54-10, 1954-1 C.B. 24, 25.

This exclusion is enforced by the courts on the grounds that (1) under the pre-existing legal obligation the margins never become the property of the cooperative and are not a part

of its income, (2) money received by one in a business transaction which he has no right to retain but must account for to another cannot be said to be a gain or profit to him, (3) patronage refunds are distributions of money belonging to the patrons rather than distributions of income of the cooperative, (4) while held by the cooperative the funds are in its hands as agent or trustee for its patrons to whom it is legally obligated to repay the same, and (5) patronage refunds are in reality discounts or rebates paid under a pre-existing legal obligation and are just as allowable as any other discount upon the purchase price of any commodity.

United States v. Mississippi Chemical Company, 326 F.2d 569, 570, (5th Cir. 1964).

"An obligation to pay a patronage dividend is destroyed to the extent that discretion to divert exists". Union Equity Cooperative Exchange v. Commissioner, 58 T.C. 397, 415 (1972). Thus, if the petitioner's board of directors had the authority to divert net earnings away from patrons, then no patronage dividend deduction is allowed for net earnings as to which that right existed, even though that right was not exercised and the funds were actually distributed to the patrons.

We believe the taxpayer's bylaws expressly permit the board of directors to divert net earnings away from patrons. Those bylaws authorize the directors to put aside up to [REDACTED] percent of net earnings or accumulations for the educational fund and a "reasonable" amount of net earnings or accumulations for whatever necessary or statutory purposes they choose. What constitutes a "reasonable" amount is unclear, but it could readily encompass the entire earnings, particularly since the discretion to choose the purposes for which the earnings are set aside also belongs to the board of directors.

In short, the board of directors has within its discretion pursuant to the bylaws the power to set aside all net accumulations. Therefore, any distributions of net accumulations were at the behest of the board of directors, were not pursuant to a preexisting obligation, and did not qualify as deductible patronage dividends.


Although we read the bylaws to grant such discretion to the board of directors, our overall poor record in litigating cooperative issues in recent years causes us concern. We are concerned that a court may interpret the bylaws to require an apportionment of reserves among patrons, so that they would be considered property of the patrons not taxable to the cooperative. A court upheld a patronage dividend deduction based on such a bylaw interpretation in The Farmers Elevator Co. of East Grand Forks, Minnesota v. Commissioner, T.C.M. 1962-204. There, however, a specific bylaw provision was clearly subject to such an interpretation. Here, the sentence in the bylaws requiring apportionment expressly applies only to "net margins."

We are also concerned because section 185.45 of the Wisconsin Statutes provides for boards of directors to set aside both reasonable reserves and up to five percent of net proceeds as an educational fund to be used in teaching cooperative organization and principles. The remainder shall be distributed and paid to patrons. In other words, the statute provides for set asides to be made by the board of directors with only the residue to vest in patrons in a manner similar to the bylaws of the cooperative in issue. Thus, we can expect the discretion granted the board of directors in this case to be prevalent in cooperatives throughout Wisconsin patterned on the state statute. We are concerned a court may be reluctant to toll the death of patronage dividend deductions by all those cooperatives through its decision in this case.

Despite these concerns, we interpret the bylaws in the subject case as granting the board of directors discretion to set aside or pay out all net accumulations. As the law is clearly established that such discretion prevents distributions from being deductions, we concur in Appeals' proposed disallowance of such deductions in their entirety. However, in light of the concerns mentioned earlier, we would encourage a settlement which reflects litigating hazards.

ROBERT P. RUWE

By:

  
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Senior Technician Reviewer  
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Attachments: Administrative File  
Form 1120 for 8212 & 8312 (originals)  
Form 1120X for 8212 (original)